American Gas Association
FERC Natural Gas Regulatory & Market Issues Seminar

AGA Headquarters
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Good Afternoon. Thank you for inviting me to your Regulatory and Market Issues Seminar. As I was reviewing the schedule for this seminar, the focus seemed to be on current issues facing the natural gas industry. I know that one issue that is of interest to all participants in this seminar is the difficulties facing the energy markets in the West. While much has been said about the situation on the electric side, my comments today will focus on the natural gas issues facing this region.

In the past several months, I have given a great deal of thought to the implications for the gas industry from the energy crisis confronting California and the West. I am concerned about the impact a prolonged period of high natural gas prices will have on electric generation costs. The cost of natural gas is the variable that has the greatest ability to influence the cost of generation. This is true for even more efficient generation plants. When gas costs were two dollars ($2), the cost of generation of a plant with a 10,000 Btu heat rate was twenty dollars ($20) per megawatt/hour. As gas costs climbed to ten dollars per MMBtu ($10), generation costs rose to approximately one hundred dollars ($100) per megawatt/hour. When natural gas prices surged to fifty dollars ($50) per MMBtu, the cost of generation at these plants soared to five hundred dollars ($500) per megawatt/hour. The impact for less efficient plants is even greater. My point is that there is volatility in the gas markets as well as the electric markets.

The extraordinarily high prices for electricity and the extreme shortages of supply have created market distortions that are affecting the lives and well-being of millions of citizens and threatens the very existence of thousands of commercial enterprises throughout the West. The magnitude of this growing crisis, and its potential disruptive capability, cannot be overestimated. I am worried about the predictions for prolonged blackouts, shortages and even higher energy prices this summer in California. Consequently, I believe that it is imperative that the Commission continue to address issues, within our authority, as expeditiously as possible.

FERC has been grappling with and attempting to resolve the market distortions in California for some time. Due to the continuing convergence of the electric and natural gas industries, problems that have affected the electric utilities in California and the West also have been felt in the natural gas industry. The Commission has taken a number specific actions recently to address those problems in the West. The Commission recognizes that the solutions to these problems will be as multi-faceted and complex as the causes. Are we prepared to make the decisions necessary to resolve the problems that are within our jurisdiction? I believe we have to be.

The Commission actions taken to date address the following issues affecting markets in the West: priority rights to California delivery points, affiliate concerns, and infrastructure needs. In addition, the Commission has key cases pending in which the issues are whether to reimpose the price cap on secondary market transactions and whether to cap prices on the sales of natural gas. These are issues that especially affect the West, but I am sure that the Commission's resolution of these issues is of interest to all in the audience today.

Concerning infrastructure needs, the Commission issued an order on March 14 aimed at removing the obstacles to increased energy supplies into the western United States. The order recognized that natural gas is an important fuel source for electric generators and that there has been a significant escalation in the market price for natural gas. However, there have been reports of pipeline capacity constraints in moving gas to where it is needed for electric generation. Consequently, in this order the Commission elaborated on actions it has taken and can take to increase pipeline capacity **where appropriate**.

Through this order, the Commission sought comments on the need to provide rate incentives to expedite construction of projects that will make additional capacity available this summer on constrained pipelines. I believe that if the Commission does provide incentives, we should be very precise regarding the activity we are encouraging and the incentives we will be willing to consider, if at all. The comments in this proceeding are in and staff is presently reviewing them.

I do have a concern about another California infrastructure issue that needs to be resolved at the state level. While FERC has jurisdiction over the siting of interstate natural gas pipelines, the states have siting authority for intrastate facilities. As a result, FERC can do its part to get adequate pipeline infrastructure to California; however, the state needs to assess whether there is sufficient intrastate capacity available to take natural gas from the border to market. I am worried that where there is insufficient takeaway capacity, FERC's actions to increase capacity to the border may result in problems, such as prorationing. If this occurs, parties may have firm rights to the border, but because of prorationing shippers can not be assured of reaching the markets. Thus, the additional infrastructure can increase uncertainty, which will be of little or no benefit to California.

The Commission has also recently addressed the uncertainty caused by the delivery point allocation scheme on the El Paso Pipeline system. Last October, the Commission issued an order, arising out of a complaint filed by Amoco, stating that the current allocation method used by El Paso was unjust and unreasonable due to the uncertainty that this method created with respect to the rights of parties with firm transportation contracts to receive firm service.

The problem arose because the Topock delivery point to SoCal Gas, which is the most economically desirable delivery point into California from the El Paso system, is being over nominated. Nominations are approximately 1,500 MMCF/day but the point has a design capacity of only 540 MMCF/day. The result is that El Paso was reducing parties' firm nominations at that point in a pro rata basis daily. Consequently, the Commission ordered El Paso to implement a delivery point allocation method under which a firm shipper must be able to schedule its contractual firm entitlements at SoCal Topock without being subject to reductions in its schedule for other than force majeure conditions. It is my hope that El Paso's new allocation methodology, which was implemented on April 1, will reduce the uncertainty of shipper's moving gas to key markets in California.

The Commission, at its last meeting, addressed a complaint filed by the Public Utilities Commission of California, the CPUC. The order dealt with an assertion by the CPUC that a contract between El Paso Pipeline and El Paso Merchant raises issues of affiliate abuse. The CPUC also maintains that the contract, which accounts for approximately one-third of El Paso's capacity into California, allows El Paso Merchant to exercise market power and artificially drive up the price of natural gas transported into California. The Commission order found that there were still disputed issues of fact that need to be examined at a hearing.

As I stated earlier, I am concerned about the nexus between the increase in natural gas prices over the last year and the high costs of electric generation in California. The Commission's order also addressed market power. Based on the facts presented by all parties, the issues of market power and withholding raised by the CPUC warrant further exploration at hearing.

Finally, I would like to note three other complaints pending before the Commission. These complaints were filed by San Diego Gas and Electric Company, the Los Angeles Department of Water and Power, and the National Association of Gas Consumers. The first two complaints concern natural gas prices in the State of California. The other filing concerns the price of natural gas nationwide. The SDG&E and the Department of Water and Power complaints seek to have the Commission immediately rescind the portion of Order No. 637 that removed the price cap for short-term capacity releases. SDG&E and the National Association of Gas Consumers also seek some form of price cap on commodity sales of natural gas.

I note these cases for two reasons. First, AGA supported the release of the price cap on secondary market transactions in its comments.

Consequently, I am sure that the AGA members are very interested in these proceedings. Second, I believe that the Commission should act on these complaints prior to the summer, which is the peak season in California. I will be keeping an open mind about these cases, but must admit that I had reservation about releasing the price cap in the Order No. 637 rulemaking proceeding. That is why I advocated so strongly to release the price cap as an experiment, with a September 30, 2002 sunset date.

The imposition of a price cap on gas sales is a more difficult proposition. The Natural Gas Wellhead Decontrol Act removed price controls over all sales defined in the NGPA as "first sales" as of January 1, 1993. Consequently, the Commission could not impose a cap on gas sales except to the extent they are sales for resale by pipelines, LDCs, or their affiliates. Such sales make up a relatively small portion of total gas sales. As a result, the Commission's ability to act on gas sales is limited.

Finally, I would like to discuss another issue that is present in California and other states, but that is out of FERC's hands. That issue is the need for LDCs and other gas purchasers to have the ability to use appropriate risk management tools. The Commission's December 15th order on remedies for California found that a major cause of the high electric prices in California was the over-reliance on the spot market for electricity. In that order, the Commission recommended that the California utilities put 95 percent of their load in forward markets to minimize exposure to the price volatility of the spot market. I believe that the same logic holds for the natural gas market, although I don't prescribe to certain percentages.

It is my understanding that the CPUC allows for recovery of gas costs that meet a benchmark determined by the use of monthly spot market purchases. It is my opinion that such a policy creates an incentive to rely on spot market purchases of natural gas. Accordingly, I would suggest that policies should be in place that provide an incentive for natural gas buyers to use risk management tools, such as price hedging and the efficient use of storage, to decrease commodity pricing uncertainties.

I strongly believe that regulators need to be careful to discern the difference between hedging to reduce exposure to price volatility, and mere speculating. Hedging should be a useful tool to decrease uncertainty, while speculating to beat the market can increase the possibility of risk. It could even be said that failing to hedge and, therefore, limit the exposure to the vagaries of the spot market, is actually speculating. Consequently, I believe that regulators in California and other states should investigate the benefits that may accrue by limiting the incentive for natural gas purchasers to gravitate toward the spot market. A balanced portfolio of long- and short-term contracts makes a great deal of sense when spot prices are at the extreme levels of the past year.

Before I take questions, I want to say that I am committed to competitive markets. I understand that there are parties criticizing FERC for doing too little and other parties asserting that no action is needed by our agency. On balance, I believe that the remedies we have laid out in our orders have been appropriate and act on the two types of structure that FERC has authority over: market structure and infrastructure. Hopefully, we can continue to correct the dysfunctions in the market in the West and still move steadily toward open and competitive markets.